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SUBJECT: Tax Reform Creates Better Business Environment, But There's More to Do

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¶1. (U) SUMMARY: As background for the upcoming Trade and Investment Framework Agreement (TIFA) talks, this report notes that major legislative changes in 2006 made a good start at reforming Mongolia's tax system, an area which has been one of the bigger problems for investors. The old corporate income tax law in particular lacked loss carry forward provisions, arbitrarily limited deductions, induced businesses to split into multiple small entities to achieve lower tax rates, and prompted widespread tax evasion and corruption by tax inspectors. Western investors less prone to engage in such shenanigans were at a disadvantage, and sought long tax holidays as a necessary part of large investments in the mining sector. Tax holidays are no longer much possible, but new corporate and personal income tax, VAT and excise tax laws sharply lowered rates and created a more rational system. Parliament is to consider changes to the customs and customs tariff law at its next session; there has been speculation that tariff rates might be raised from 5% to 10% to compensate for lower VAT rates. High social welfare taxes remain a problem, and the World Bank notes that, to ensure an improved business climate, better tax laws must be matched by thorough reform of the dysfunctional and corrupt tax administration. End Summary.

## The Old Law: Not Business Friendly

¶2. (U) Major tax reforms in 2006 greatly improved the business environment in Mongolia for both foreign and domestic investors. Before the reforms, a World Economic Forum survey of Mongolian business executives cited tax rates and the complexity of tax regulations as two of the top five problems for doing business in Mongolia. The tax reforms were the culmination of two years of technical assistance from USAID's Economic Policy Reform and Competitiveness Project (EPRC). The reforms affected the Personal Income Tax (PIT) and Corporate Income Tax (CIT) codes as well as the VAT and excise tax codes. (Note: Reftel describes the details of the changes, and EPRC has a number of useful and informative guides on

their website: http://www.eprc-chemonics.biz.)

¶3. (SBU) The old corporate income tax system's lack of a loss carry-forward provision as well as arbitrary caps on deductions for business expenses discouraged investment; businesses could easily end up owing tax, even if they lost money. The old law was so dismal and at variance with world norms that it was a prime reason why mining investors sought tax holidays under stability agreements. (Comment: In turn, tax holidays, such as the one for Boroo Gold, helped pave the ground for populist anger on mining projects, since they set up arguments that foreign miners intended to reap huge profits from Mongolia's minerals while paying little or nothing to the government.)

¶4. (SBU) The old law created powerful incentives for avoidance and evasion. Firms -- including most Western firms -- unwilling to engage in tax evasion were at a severe financial disadvantage to companies which were less scrupulous. Large firms broke into numerous accounting entities to avoid the second tier of the CIT schedule, which doubled rates after 100 million MT (US$80,000) in income. Such practices created duplicate boards and administrative staff, which drained human and material resources from cash-starved businesses. The government dispatched tax inspectors to visit nearly 11,000 of the roughly 26,000 corporate taxpayers registered in 2004, and four-fifths of these visits resulted in fines being assessed for alleged violations of the complex tax code. Corruption among tax inspectors has been rife, and businesses might negotiate a lower fine in exchange for something under the table -- or face higher fines if they refused to pay off the inspectors. (Note: One U.S. firm with a Mongolia office, for instance, is engaged in a bitter audit dispute with tax authorities, and has charged that the inspectors sought bribes.)



In With the New
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¶5. (U) The new laws became effective January 1 (except the new excise tax law, which went into effect last July 1). In general, the new laws reduce tax rates, flatten the tax schedule, remove discriminatory loopholes and exemptions, and introduce appropriate deduction opportunities for corporate investment. By lowering the income tax rates, the Government of Mongolia hopes to encourage individuals and businesses to leave the "shadow economy," which has been estimated at half as large as the formal economy or greater.

¶6. (U) The new corporate income tax law allows firms to loss carry-forward for two years after incurring the loss, potentially encouraging investment and accommodating firms experiencing temporary negative shocks. While most businesses approve of this provision, many note that the two year carry forward limit is insufficient for projects with long development lead times, as is typical of most large-scale mining developments. The new law allows firms to deduct more types of legitimate business expenditures: training, business travel, cafeteria expenses, etc. The new law levels the playing field between foreign and domestic investors, eliminating the majority of discriminatory tax exemptions and holidays (most of which favored international investors).

Unfinished Business (Including Customs Rates)
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¶7. (SBU) Parliament is scheduled to take up additional tax reform measures in its spring session, which begins in April. These include revisions to the law on customs and customs tariffs. There has been speculation, including some from Members of Parliament, that customs rates would rise from 5% to 10% in order to recoup the revenue shortfall from reducing VAT rates. While the exact nature of the proposed changes in the customs law have been murky, Ministry of Industry and Trade counterparts aver that the changes will be consistent with Mongolia's WTO obligations.

¶8. (SBU) Parliament also is eventually expected to lower the current high social welfare levies on labor. The high rates promote tax evasion, including through hiring illegal foreign workers

(largely Chinese), an especially undesirable result in view of Mongolia's high unemployment rates. Even legal foreign labor can sometimes have a cost advantage over locals, since no social welfare taxes are due, and this is a savings often greater than the foreign worker fee to the government (changes made in the mining law, however, make it much more difficult and expensive to hire large numbers of foreign workers in that sector).

¶9. (U) The World Bank has warned that last year's legislative changes by themselves will not be sufficient to improve Mongolia's business environment. Reform efforts, they urge, need to go beyond changes to the tax code or passage of anti-corruption legislation to restructure the operations of the key agencies - the tax department, the customs administration and the inspections agency - that directly interact with private firms and individuals. The World Bank has embarked on a two-year program with the government to begin to reform the tax administration system.

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